

806 KAR 7:110. Derivative instruments.

RELATES TO: KRS 304.7-361, 304.7-405, 304.7-417, 304.7-419, 304.7-421, 304.7-457, 304.7-469, 304.48-060, 304.49-010, 304.49-020, 304.50-035, 15 U.S.C. §§ 78 et seq.

STATUTORY AUTHORITY: KRS 304.2-110(1), 304.7-367

NECESSITY, FUNCTION, AND CONFORMITY: KRS 304.2-110(1) authorizes the Commissioner of Insurance to promulgate administrative regulations necessary for, or as an aid to, the effectuation of any provision of the Kentucky Insurance Code, as defined in KRS 304.1-010. KRS 304.7-367 authorizes the commissioner to promulgate administrative regulations to implement the provisions of KRS Chapter 304, Subtitle 7. This administrative regulation sets standards for the prudent use of derivative instruments in accordance with KRS 304.7-419.

Section 1. Definitions. (1) "Business entity" is defined by KRS 304.7-012(8).

(2) "Commissioner" is defined by KRS 304.1-050(1).

(3) "Counterparty exposure amount" is defined by KRS 304.7-012(19).

(4) "Department" is defined by KRS 304.1-050(2).

(5) "Derivative instrument" is defined by KRS 304.7-012(22).

(6) "Insurer" is defined in KRS 304.1-040.

(7) "Over-the-counter derivative" means a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse.

(8) "Qualified clearinghouse" is defined by KRS 304.7-012(67).

(9) "Qualified exchange" is defined by KRS 304.7-012(68).

(10) "Qualified foreign exchange" is defined by KRS 304.7-012(69).

Section 2. Applicability. The provisions of this administrative regulation shall not apply to:

(1) Captive insurers licensed in accordance with KRS 304.49-020, except for industrial insured captive insurers pursuant to KRS 304.49-010(8);

(2) Workers' compensation self-insured groups certified in accordance with KRS 304.50-035; and

(3) Liability self-insurance groups certified in accordance with KRS 304.48-060.

Section 3. Amount of Credit Risk. (1) The amount of credit risk shall equal:

(a) The market value of the derivative instrument issued through a qualified clearinghouse if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or

(b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

(2) If derivative instruments are entered into through a qualified clearinghouse pursuant to a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed by the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

(a) The market value of the derivative instruments issued through a qualified clearinghouse entered into pursuant to the agreement, the liquidation of which would result in a final cash payment to the insurer; and

(b) The market value of the derivative instruments issued through a qualified clearinghouse entered into pursuant to the agreement, the liquidation of which would result in a final cash

payment by the insurer to the business entity.

(3) For open transactions, market value shall be determined at the end of the most recent quarter of the insurer's fiscal year and shall be reduced by the market value of acceptable collateral held by the insurer or placed in escrow by one (1) or both parties.

Section 4. Guidelines and Internal Control Procedures. (1) Before engaging in a derivative transaction, an insurer shall establish written guidelines, approved by the commissioner pursuant to Section 5 of this administrative regulation, that shall be used for effecting and maintaining derivative transactions. The guidelines shall:

(a) Specify insurer objectives for engaging in derivative transactions and derivative strategies and all applicable risk constraints, including credit risk limits;

(b) Establish counterparty exposure limits and credit quality standards;

(c) Identify permissible derivative transactions and the relationship of those transactions to insurer operations including a precise identification of the risks being hedged by a derivative transaction; and

(d) Require compliance with internal control procedures.

(2) An insurer shall have a written methodology for determining whether a derivative instrument used for hedging has been effective.

(3) An insurer shall have written policies and procedures describing the credit risk management process and a credit risk management system for over-the-counter derivative instrument transactions that measures credit risk exposure using the counterparty exposure amount.

(4) An insurer's board of directors shall, in accordance with KRS 304.7-361:

(a) Approve:

1. The written guidelines, methodology, and policies and procedures required by subsections (1), (2), and (3) of this section; and

2. The systems required by subsections (1) and (2) of this section;

(b) Determine whether the insurer has adequate professional personnel, technical expertise, and systems to implement investment practices involving derivatives;

(c) Review whether derivatives transactions have been made in accordance with the approved guidelines and consistent with stated objectives; and

(d) Take action to correct any deficiencies in internal controls relative to derivative transactions.

Section 5. Commissioner Approval. Written documentation explaining the insurer's internal guidelines and controls governing derivative transactions shall be submitted for approval to the commissioner. The commissioner shall have the authority to disapprove the guidelines and controls proposed by the insurer if the insurer cannot demonstrate the proposed internal guidelines and controls would be adequate to manage the risks associated with the derivative transactions the insurer intends to engage in.

Section 6. Documentation Requirements. An insurer shall maintain the following documentation and records relating to each derivative transaction:

(1) The purpose or purposes of the transaction;

(2) The assets or liabilities to which the transaction relates;

(3) The specific derivative instrument used in the transaction;

(4) For over-the-counter derivative instrument transactions, the name of the counterparty and the market value; and

(5) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade and the market value.

Section 7. Trading Requirements. Each derivative instrument shall be:

- (1) Traded on a qualified exchange;
- (2) Entered into with, or guaranteed by, a business entity;
- (3) Issued or written with the issuer of the underlying interest on which the derivative instrument is based; or
- (4) Entered into with a qualified foreign exchange.

Section 8. Effective Date. The requirements of this administrative regulation shall not be implemented or enforced prior to the effective date determined pursuant to KRS 13A.330, or July 15, 2014, whichever is later. (39 Ky.R. 1086; 1405; eff. 2-1-2013; Crt eff. 2-26-2020.)